No. 10806

In the United States Circuit Court of Appeals for the Ninth Circuit

BARNHART-MORROW CONSOLIDATED, A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
SEWALL KEY,
A. F. PRESCOTT,
LEONARD SARNER,
Special Assistants to the Attorney General.

INDEX

CITATIONS

Cases:

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10806

Barnhart-Morrow Consolidated, a corporation, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court of the United States (then the Board of Tax Appeals) (R. 184–213), is reported in 47 B. T. A. 590. The order of February 29, 1944, denying the motion for rehearing (R. 296–300), is unreported.

JURISDICTION

This case involves the income tax liability of Barnhart-Morrow Consolidated, a California corporation, for the calendar years 1936 and 1937. Notice of deficiencies was mailed on September 18, 1940 (R. 41), and the petition for redetermination was filed with the Tax Court on December 13, 1940 (R. 1), pursuant to Section 272 (a) of the Internal Revenue

Code. The denial of the motion for rehearing was entered on February 29, 1944. (R. 300.) The petition for review was filed on May 15, 1944. (R. 300–305.) The jurisdiction of this Court rests on Sections 1141 and 1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

Whether under the evidence the Tax Court was not correct in determining that taxpayer:

I. Was not insolvent and in receivership in 1936, within the meaning of Section 14 (d) (2) of the Revenue Act of 1936?

II. Was not entitled to a rehearing on the question of the applicability of the deficit credit provision of Section 26 (c) (3) of the Revenue Act of 1936, to its 1936 undistributed net income?

III. Had expressly waived raising and was not entitled to a rehearing to question the disallowance of additional receivership expenses for 1936?

IV. Had not sustained the burden of proving the amount of any loss sustained in the relinquishment or exchange of its one-half interest in Well No. 16 in 1937?

STATUTES INVOLVED

The applicable provisions of the statutes involved are set out in the Appendix, *infra.*

STATEMENT

Taxpayer is a California corporation organized in 1926 to operate and manage oil and gas wells. (R. 186.) It kept its books and filed its returns on the accrual basis. (R. 186.) In 1927 it acquired

by assignment the right to operate five oil and gas wells in the Santa Fe Springs field, known as Julian Wells Nos. 1, 2, 3, 11, and 12. (R. 68, 186, 187.) On March 9, 1928, W. J. Barnhart, acting for C. C. Julian (R. 188), acquired the United lease (R. 187), and on September 28, 1928, taxpayer agreed with Barnhart to drill at its own expense a well on the property to productive sands below 5,000 feet (R. 187). After payment of landowner's royalty of 16⅔% if a well was drilled less than 5,000 feet, and 20% if drilled more than 5,000 feet, taxpayer was entitled to receive $100,000 out of the remaining production. Thereafter the 83⅓% interest of the lessee was to be divided equally between taxpayer and Barnhart after paying operating expenses, except that Barnhart's interest was not chargeable with more than $250 per month while the well was flowing, and $500 per month while the well was being pumped. (R. 187–188.) Taxpayer also agreed to pay C. C. Julian the sum of $2,500 to be relieved of its obligation to drill a well deeper than 5,000 feet, and to accept $80,000 instead of $100,000 for the drilling of such well. (R. 188.) Thereafter, taxpayer drilled a productive well on property known as Julian Well No. 16 to a depth of less than 5,000 feet. (R. 188.)

Julian, acting through Barnhart, thereafter assigned his interest in Well No. 16 mediately to J. A. Smith. (R. 188–189.) Taxpayer and Smith then were the owners of Well No. 16.

In 1930 taxpayer undertook to operate Well No. 17, which had been drilled by Julian on another part of the United lease. (R. 189.)

All the above mentioned wells were allegedly purchased by R. L. Mack in an execution sale held to satisfy a judgment obtained by one Garliepp against Julian in 1929. (R. 190.) Mack conveyed his interest to W. A. Schwartz,[1] who thereupon claimed to be the owner of the wells, except for the royalty interests. On January 19, 1931, Julian instituted suit in the California state court to restrain Schwartz from taking possession of the wells. (R. 190.) On March 19, 1931, the court appointed two individuals as receivers to operate the wells under existing leases, sell the production of the property, paying therefrom royalties and expenses incident to the receivership and the operation of the wells, and retain other funds until further order of the court. (R. 190.) On March 23, 1932, pursuant to a stipulation of all the parties to the action, the court appointed two trustees to operate the wells, but continued the receivership for the purpose of carrying on the litigation. (R. 190.) Judgment was entered in the case on September 7, 1933. The court held that taxpayer and J. A. Smith were each entitled to one-half interest in Well No. 16, subject to the terms of the lease entered into on March 9, 1928. (R. 190–191.) The judgment was affirmed by the District Court of Appeals on August 28, 1936. *Julian* v. *Schwartz,* 16 Cal. App. 2d 310. The case was finally determined on October 28, 1936, upon the denial of a hearing by the Supreme Court of California. (R. 191.)

---

[1] Schwartz is the nominee or straw man for J. A. Smith (*Julian* v. *Schwartz*, 16 Cal. App. 2d 310, 316).

On or about July 29, 1931, D. R. Morrow brought an action in the state court of California against taxpayer, Hardison, and Barnhart, for an accounting of the affairs of taxpayer; for an accounting to taxpayer by Barnhart, general manager, and Hardison, president of taxpayer, for any and all profits including secret profits, and for unlawful payments set forth in the complaint; contesting unlawful and excessive salaries paid to Barnhart and Hardison; and for the appointment of a receiver to take charge of the affairs and assets of taxpayer *pendente lite*. It was alleged in the complaint that Barnhart and Hardison had caused to be paid to themselves and credited to them excessive salaries from 1928 in the amount of $1,000 each per month. On the same day the court appointed Ralph S. Armour as receiver for taxpayer. (R. 191–192.)

The questions relating to a salary of $14,000, which had been accrued on taxpayer's books in favor of Hardison, and notes in the amount of $8,500 payable by taxpayer to Hardison, were not settled until December 11, 1936, when the board of directors of taxpayer authorized the payment of $7,000 to him for salary to December 30, 1930. At that time Hardison admitted that the salary accrued in his favor was excessive. (R. 192–193.) The remainder of the salary, being for the first seven months of 1931 during which taxpayer's affairs were in the hands of the receiver appointed in connection with the *Julian* v. *Schwartz* litigation, was not recognized and paid. Such salary

was written off in 1936 as of 1931 and credited to surplus.[2] (R. 146, 193.)

The net income or the net loss of taxpayer each year from 1930 to 1935 was as follows (R. 193):

	Net Income	Net Loss
1930	$3, 175. 54	
1931		$90, 116. 67
1932		5, 213. 85
1933	666. 27	
1934		2, 516. 00
1935		6, 063. 64

In accordance with the instructions of the court, the trustees kept a record of the income and operating expenses of each well. On July 23, 1934, the court issued an order directing the trustees to pay from the funds in their possession certain amounts including $102,885.93 to taxpayer. (R. 193.) The court order was ineffective during the pendency of the appeal in the *Julian* v. *Schwartz* litigation. It became effective on October 28, 1936, when the case was finally determined and adjudicated. The amount of cash distributed to taxpayer in 1936, pursuant to the order, was $112,000. In 1937 taxpayer received an additional sum of $121,037.94 from the proceeds, pursuant to a court order entered in February, 1937. The trustees paid the sum of $17,852.13 to the receiver in 1936 for the account of taxpayer. (R. 193–194.)

While the proceeding was pending, Ralph S. Armour, the receiver of taxpayer, was never in complete charge or control of the assets of taxpayer,

[2] The notes payable in the sum of $8,500 were also canceled.

since the oil wells at Santa Fe Springs were in control of and being operated by the trustees. (R. 194.) Thus, the assets shown in the balance sheet (Ex. 51; R. 103, 194–195) as capital assets, except a well known as the Hartley Well (not carried as an asset after 1930), and office furniture and fixtures shown in the books after 1931 as a value of $811.50, were not in the possession of taxpayer from the time of the appointment of the receiver in 1931 until the final determination of the *Julian* v. *Schwartz* litigation in 1936, and were being claimed by Schwartz and others, as asserted in the proceeding. (R. 195.) The financial condition of taxpayer remained about the same from January 1, 1936, until the receipt in 1936 of funds from the trustees. (R. 195–196.)

The income and expenses of taxpayer for 1936 were as follows (R. 196):

INCOME		
Oil and gas sales after November 1, less expenses		$6, 436. 30
Rental on drilling equipment		5, 000. 00
Distribution from trustees		142, 989. 99
Claim for interest relinquished		391. 67
		154, 817. 96
EXPENSES		
Interest paid	$1, 409. 36	
Loss, erroneous payments to J. A. Smith	16, 500. 10	
Receivership	17, 574. 68	
		$35, 484. 14
Net income		119, 333. 82

None of the income impounded by the trustees in the *Julian* v. *Schwartz* litigation was considered as income to taxpayer until released to it. In and after 1933, pursuant to a stipulation filed with the court in 1933, there were released to J. A. Smith for the account of

taxpayer proceeds of gas production of Wells Nos. 1, 2, 3, and 11 accruing to taxpayer. (R. 196.) At a hearing held in Washington, D. C., on August 13, 1937, these amounts were determined to have been constructively received by taxpayer in 1933 and years subsequent thereto. There was deducted from such income depreciation on the tangible equipment of the wells and other tangible lease equipment which was then being used by the trustees. In addition to the depreciation so deducted, there were deducted and allowed business expenses paid and accrued, including legal fees and receivership expenses. The receivership expenses so allowed were allowed as deductions in and for the years ~~for~~ in which they were definitely determined and approved by the court. (R. 85, 196–197.)

On November 12, 1936, Ralph S. Armour, receiver, filed with the court a final account and report showing that during the period of the receivership he had incurred expenses, aggregating $17,852.12, for the years 1931 to and including 1936 with the exception of 1935. (R. 197.)

The court approved the account the day it was filed. In its order approving the account, the court said (R. 198):

> * * * it appearing to the court that defendant, Barnhart-Morrow Consolidated, a corporation, is no longer insolvent by reason of its success in the litigation entitled: *Julian* v. *Schwartz,* No. 315–345, in this court, now finally determined on appeal, and that by reason of the termination of said litigation and the present solvency of said corporation, there is no

> longer any reason for the continuance of said receivership herein * * *

and directed that the receiver's expenses be paid out of the first moneys accruing and paid to taxpayer.

The taxpayer's share of the gross proceeds of production of Julian Wells Nos. 1, 2, 3, 11, 16, and 17 for the period of December 1, 1930, to November 14, 1936, during which time the wells were in possession of and being operated by the trustees, was $488,903.65. The total charges made against taxpayer by the trustees for the operation of the wells during that period were $223,352.83, leaving a balance of $265,550.82 payable to taxpayer. Of the net amount of impounded funds due taxpayer, $142,989.99 was paid to it in 1936, $122,371.37 in 1937, and the balance of $189.46 in subsequent years. The payment made in 1936 consisted of the following items: cash paid to Ralph S. Armour, receiver, for receivership expenses, $17,852.13; cash to taxpayer, $112,000; depreciated cost of well equipment acquired by trustees and delivered to taxpayer on November 14, 1936, $7,992.90; compensation insurance, $300; liabilities of taxpayer paid by trustees, $4,844.96. (R. 198–199.)

The taxpayer sustained an operating loss of $3,258.78 in the operation of Well No. 16 in 1937 up to the time it ceased producing because of unknown damage to the well. Work of an undescribed nature on the well was necessary to ascertain the kind and extent of the damage and the cost of making repairs. J. A. Smith, the owner of the other one-half interest in the well, including its equipment, was not liable for more than

$250 per month for operating expenses of the well. (R. 117, 124, 199.)

The terms of the United lease required taxpayer to operate Well No. 16 even though in doing so it sustained a loss (R. 124, 199), and in the event that taxpayer abandoned the well the lessor had the right to take possession thereof, including its equipment, and hold or operate the property at its own expense, free from any claim of the taxpayer, subject, however, to a royalty of 8⅓% to taxpayer. In case the lessor did not exercise the right to take over any abandoned well, taxpayer was obligated to restore the premises to their original condition, including the plugging of the well in accordance with the laws of California. (R. 134, 199.) The cost of plugging a well is from $5,000 to $10,000. (R. 134, 199.) The well had some salvage value, probably $2,000. (R. 125, 199.)

In December 1937, Harold G. Morton, an experienced oil operator and counsel, and a director and stockholder of taxpayer, suggested to the board of directors of taxpayer that the well be abandoned. At that time J. A. Smith held about 35% of taxpayer's stock and Harold G. Morton and another individual each held about 9%. (R. 126, 199–200.) The remainder of the stock was widely distributed. On December 20, 1937, the board of directors of taxpayer adopted a resolution to surrender the well, and the premises pertaining thereto, to J. A. Smith and executed a quitclaim deed for the property in his favor. (R. 100, 200.)

Work done on the well immediately thereafter by J. A. Smith revealed that the liner thereof had

crumpled. The damage was repaired at a cost of about \$800. The well sustained similar damage in 1936 and was repaired at a cost of about \$18,000. (R. 130–131, 200.)

The well was placed on production in January 1938, in which month it produced oil and gas of a value of about \$1,500. The gross production of the well was increased to \$2,550 in April, 1938, and thereafter it decreased to \$700 or \$800 in October 1941. (R. 132–133, 200.)

The Tax Court, in its opinion of August 20, 1942, held, *inter alia,* that taxpayer had not sustained the burden of proving that it was insolvent and in receivership in 1936, within the meaning of Section 14 (d) (2) of the Revenue Act of 1936 (R. 207) or the amount of any loss it sustained in connection with the transfer of its interests in Well No. 16 in 1937 (R. 213). On September 17, 1942, taxpayer filed a motion for rehearing and reconsideration of the insolvency and Well No. 16 issues (R. 214–243, 296), which was denied by the Tax Court on December 4, 1942 (R. 244–246, 296–297). After the approval of the Revenue Act of 1942, on October 21, 1942, no motion was filed to apply Section 501 of that Act, which added Section 26 (c) (3) to the Revenue Act of 1936, by the presentation of additional evidence or otherwise, nor was any application made to amend the pleadings to cover the issue. (R. 297.) The question of whether, under such section, taxpayer was a deficit corporation on December 31, 1935, was first suggested, and taxpayer's contention was first set forth in a Rule 50 recomputation filed by taxpayer on March 26,

1943, by reference to the balance sheet of December 31, 1935 (R. 103–104), showing an alleged deficit of $172,161.65 (R. 246, 297). The necessity for further evidence on the issue was not alleged and the insolvency and Well No. 16 questions were not again raised.[3] (R. 246, 297.)

On May 5, 1943, at the hearing on the recomputations, taxpayer submitted the deficit credit matter upon the facts already in the record, and elected not to file a memorandum on this subject, stating that the facts were already in the record. (R. 263–267, 297–298.) After consideration of the evidence on record, which consisted of the balance sheet at the close of 1935 (R. 103–104), the Tax Court modified and supplemented its order of December 4, 1942, on other issues only (R. 270, 298). Revised recomputations were ordered filed (R. 298) and the application of Section 501 was again presented in recomputation, with no suggestion of additional evidence being necessary R. 273, 298).[4] The matter came on for hearing on January 5, 1944, after continuance at taxpayer's request (R. 298), and was decided adversely to taxpayer on January 24, 1944 (R. 285). On February 17, 1944, taxpayer filed another motion for rehearing on the grounds the Tax Court did not consider the applicability of Section 26 (c) (3), that additional evidence would be submitted, consisting of an analysis of the deficit account, and that the Tax Court erred in holding the taxpayer was not

[3] Among the deductions claimed were the disallowed receivership expenses. (R. 250.)

[4] See footnote 3.

insolvent in 1936, was not entitled to deduct the additional receivership expenses, and did not prove the amount of its loss in relinquishing its interest in Well No. 16. (R. 4, 286–291, 296.)

In denying the motion, the Tax Court held that the insolvency and Well No. 16 issues had previously been thoroughly considered, that the matter of receivership expenses was waived at the original hearing, and was not discussed in taxpayer's briefs nor at the hearing under Rule 50, and that no newly discovered evidence relating to the deficit credit question was suggested. (R. 296–300.) From the decision of the Tax Court sustaining the determination of deficiencies in taxpayer's income tax for 1936 and 1937, taxpayer prosecutes this appeal.

SUMMARY OF ARGUMENT

1. Taxpayer was not insolvent in 1936, within the meaning of Section 14 (d) (2). Its assets greatly exceeded its total liabilities, and it did not demonstrate that it was unable to meet its liabilities as they matured. The only substantial business activity carried on was the operation of the wells by the trustees in the *Julian* v. *Schwartz* litigation, and they admittedly from the proceeds from the sale of oil, paid the cost and expenses of the operation of the wells. No other liabilities were shown to have matured or have been due and payable in 1936. Insolvency denotes a "general" inability to meet liabilities as they mature by means of either available assets or use of credit, and "meet" is not to be construed as "pay". The balance sheet can justifiably be interpreted to show that if

some liabilities existed, they were met by the employment of credit which obtained renewals and extensions of time.

2. Taxpayer had full opportunity to present its case before the Tax Court. It voluntarily and expressly chose to have the question of the deficit credit provision of Section 26 (c) (3) of the Revenue Act of 1936 decided on the state of the record as it now exists. The only evidence of record is a balance sheet as of December 31, 1935, showing an alleged deficit of $172,161.65, but which does not purport to show the deficit to be in accumulated earnings and profits. The record evidence is insufficient to allow the credit, and although the motion for rehearing is directed toward an analysis of the deficit account, nothing newly discovered, since the taxpayer elected not to present additional evidence, is suggested. Under California law it was in no way prohibited from paying dividends in 1936. It was a wasting asset corporation and had net profits during 1936, from which cash dividends could have been paid, even though its assets might have been somewhat impaired.

3. The matter of the disallowance of additional receivership expenses for 1936, although put in issue by the pleadings, was expressly waived by taxpayer at the proceeding before the Tax Court, and was not discussed in the briefs nor at the hearing under Rule 50. Taxpayer, therefore, is precluded from raising the question on this appeal. The claim, moreover, has no merit, since taxpayer had stipulated with representatives of the Bureau of Internal Revenue that the receivership expenses were to be allowed as deductions

in and for the years in which they were definitely determined and approved by the state court having jurisdiction over the receiver. This does not mean, as taxpayer asserts, for and in the year the court did the approving. Although the state court approved the receiver's account in 1936, it did so for the incurrence of expenses for the years 1931 to and including 1936, with the exception of 1935. Taxpayer presumably has already taken the benefit of these deductions in computing its taxable income for these prior years, and cannot now obtain a double benefit by the allowance of the deductions again for the year 1936.

4. Taxpayer failed to prove the amount of any loss sustained on the relinquishment or sale of its one-half interest in Well No. 16 to Smith. It introduced no evidence for the purpose of showing the adjusted cost or other basis of the well. The only evidence in the record is an exhibit which was offered—

> not for the purpose of showing that it is evidence of the fact that they did sustain [a loss of $43,151.96] but to show how we arrived at that figure, to show our method of computing.

Since the amount of the loss was contested from the outset of the hearing before the Tax Court, there was no abuse of discretion by that court in its refusal to open the case and retry the issue. Moreover, by the transfer, taxpayer was relieved from the terms of a very undesirable operating contract and released from any personal liability for conditioning the well for purposes of abandonment under California law. Taxpayer thus received a *quid pro quo* from the transfer, and Smith took the whole interest in the well, burdened

615699—44——3

with the liability of conditioning it in the event of abandonment. This constituted a sale or exchange of a capital asset within the meaning of the $2,000 limitation provision of Section 117 (d).

ARGUMENT

I

Taxpayer was not insolvent and in receivership in 1936, within the meaning of section 14 (d) (2) of the Revenue Act of 1936

The sole question on this phase of the case is, as stated by taxpayer (Br. 6), whether it was insolvent in the equity or commercial sense. The Government does not, in the light of the decision of this Court in *Artesian Water Co.* v. *Commissioner,* 125 F. 2d 17, argue that a receivership contemplated by Section 14 (d) (2) (Appendix, *infra*) was intended to mean one caused by financial difficulties and not one arising, as here, from disputes between shareholders and directors over secret profits, excess salaries, and mismanagement. (R. 191–192.) However, it is desired to preserve that question. Nor does taxpayer even assert that it was insolvent in the bankruptcy sense of having liabilities in excess of assets. The mere fact that an appeal was pending from the determination in its favor of litigation over title to the bulk of its assets obviously does not justify the exclusion of these assets from the balance sheet any more than do the countless law suits to which a common carrier is constantly being subjected and which represent contingent liabilities restricting in some sense absolute disposal of property. See Glenn, Liquidation, Sec.

19. Time is not of the essence, for this purpose, and the successful termination of the litigation corroborates taxpayer's prior solvency.

To prevail, taxpayer must therefore demonstrate that it was unable to meet its obligations as they matured by available assets or a reasonable use of credit. *United States* v. *Anderson Co.*, 119 F. 2d 343 (C. C. A. 7th); *Artesian Water Co.* v. *Commissioner, supra.* And since this is a question of fact (Fletcher, Corporations, Sec. 7365), it must show further that in so far as this is an accounting problem the Tax Court's holding was clearly erroneous. *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231.

That all of taxpayer's oil and gas properties were in the possession and control of the trustees appointed by the court in the *Julian* v. *Schwartz* litigation does not materially affect the question of taxpayer's solvency. For when the California court originally appointed the trustees (then called receivers), they were authorized to operate the wells, collect the proceeds, pay royalties and all necessary operating expenses in connection with the wells and receivership. And during the year 1936, they were empowered to pay from the proceeds from the sale of oil, the cost and expenses of the operation of the wells. In so far as there was any substantial business activity, it was carried on by the trustees. No suggestion can seriously be advanced that they were unable to meet their obligations as they matured. During the time the wells were in possession of and being operated by the trustees, taxpayer's share of the gross proceeds of

production was $488,903.65, with total charges for the operation of the wells being $223,352.83, leaving a balance of $265,550.82, almost all of which was paid to taxpayer in 1936 and 1937. (R. 198.) In the commercial or equity sense, insolvency has to do with the inability to run a going business, to make ends meet. There was no such inability here. The situation cannot be distinguished from taxpayer's setting up for accounting purposes a separate department to operate and manage the wells. Had this been done, no one could successfully assert taxpayer was therefore rendered insolvent.

But taxpayer bottoms its contention upon corporate liabilities, which it claims could not be paid out of proceeds from the production of the wells until the litigation terminated in its favor. Mention is also made that in four of the six years from 1930 to 1935, it suffered a net loss. (R. 193.) However, a net operating loss is no proof of insolvency (*Shonnard* v. *Elevator Supplies Co.,* 111 N. J. Eq. 94; *Argalas* v. *Frank Theiss Co.,* 115 N. J. Eq. 561); and an examination of the comparative balance sheets (*United States* v. *Anderson Co., supra*), reflects the weakness of taxpayer's position.

Cases construing the present New Jersey Business Corporations Act (New Jersey Statutes Annotated, Sec. 14–3), which deals with the appointment of a receiver for an insolvent corporation, are cited by most of the authorities as controlling examples of insolvency in the equity sense. Glenn, Liquidation, Sec. 13; Gerdes, Corporate Reorganizations, Sec. 96; Fletcher, Corporations, Sec. 7360. Insolvency in this sense de-

notes a "general" inability to meet liabilities as they mature by means of either available assets or an honest use of credit. *Hersh* v. *Levinson Bros., Inc.,* 117 N. J. Eq. 131; *Artesian Water Co.* v. *Commissioner, supra.* And the word "meet" is not to be construed as "pay". *Hoagland* v. *United States Trust Co.,* 110 N. J. Eq. 489, 502. A temporary financial embarrassment may be alleviated by the employment of credit to obtain renewals of bills payable and an extension of time for the payment of other obligations. If this is done, no insolvency exists. *United States* v. *Anderson Co., supra; Hersh* v. *Levinson Bros., Inc., supra.*

An examination of the balance sheet at the close of 1935 (R. 103–104) reveals that even eliminating the disputed capital stock issued for services and leases, there existed some $44,000 worth of liabilities to some $350,000 worth of assets. Apparently there was no substantial change prior to the termination of the trusteeship in 1936. (R. 205.) The Tax Court pointed out that except for the salary to Hardison, which was claimed to be excessive in the shareholders' suit, there was no showing whatever that these liabilities matured during the receivership or were due and payable during the taxable year 1936. (R. 206.) Taxpayer claims that because they were listed on the balance sheet under such headings as notes and accounts payable, this shows they were not contingent and unmatured. The litigation over the $14,000 salary item (R. 206), demonstrates that this amount was contingent and not to be considered as a liability for purposes of insolvency (Glenn, Liquidation, Sec. 19), and it cannot seriously

be suggested that notes and accounts payable always represent obligations already due. They may just as well signify obligations to become due within a certain period of time. Kester, Principles of Accounting 29.

Since taxpayer would not be insolvent if it were able in 1936 to meet, as distinguished from pay, its liabilities, it is interesting to note their nature. Fourteen thousand dollars was owed to Hardison, who was the president of taxpayer. (R. 192.) Not only was this a contingent liability because of the dispute but Hardison had previously agreed that he would accept $7,000 in full payment of all salary claims, and further, would acquiesce in the cancellation of notes of the corporation which he held in the sum of $8,500. (R. 193.) Thus, this creditor, who was the president of taxpayer, in no way was pressing it for payment and was amicably seeking an adjustment of the claim. Taxpayer was able to meet this pecuniary liability, assuming it existed, by securing an extension and renewal, as evidenced by the prior agreement. The fact is was able to do so shows that it had credit at its disposal (*Hoagland* v. *United States Trust Co., supra*), and that $8,500 worth of notes, together with the salary claimed, did not have to be immediately taken care of during the ten months of 1936. So also for the amount of $6,995.63 due shareholders. (R. 104.) That this sum remained constant since 1931 may well demonstrate that the shareholders were not seeking immediate payment of their claims, even if they were then due. As part owners of the enterprise, realizing their best interests depended upon the successful outcome of the litigation, the Tax

Court could surely draw the inference that they were content to sit back and wait for payment until the termination of the controversy. The amount of $4,518.22 was an account receivable from J. A. Smith, a principal shareholder, contra the indebtedness due him. (R. 103.) Taxpayer may say this therefore was not an asset (Br. 12), but surely it reduced on the liability side the amount due to stockholders, which must have included Smith. The $21,978.09 due from Barnhart, although it remained constant for several years, was listed as an amount receivable beyond one year. There is no showing it was already due and unpaid and therefore not worth anything. From the bare appraisal of the balance sheet, the Tax Court could reasonably impute as much substance to it as to the few liabilities portrayed.

That the Tax Court may have made a "glaring error" (Pet. Br. 10), in construing capital stock issued for services and leases (R. 103) as an asset which could be used as security for a loan or sold to pay debts, is unimportant. Taxpayer's credit was available and used, if the liabilities had any substance, to secure extensions until the appeal was decided in its favor. Obviously, taxpayer can get no help from the statement in the state court's order of November 12, 1936, dissolving the receivership, that taxpayer was no longer insolvent by reason of its success in the *Julian* v. *Schwartz* litigation. (R. 198.) As the Tax Court said (R. 206–207):

> It does not appear that the court ever had before it the question of solvency or insolvency of * * * [taxpayer]. Neither does it ap-

> pear that any of the parties in interest ever alleged such a fact in pleadings before the court. On the contrary, the complaint filed by D. R. Morrow, which resulted in the appointment of the receiver, alleged, among other things, that the corporation had been in a prosperous condition and was then operating at a profit, but that the profits were being diverted from the stockholders and * * * [taxpayer].

Whether the Tax Court did or did not use language contrary to the decision of this Court in the *Artesian Water Co.* case, as taxpayer asserts (Br. 12), is totally irrelevant.[5] We do not have here a situation where by reason of the impounding of the assets in the trusteeship, taxpayer was unable to meet maturing obligations. The operating expenses were paid for by the trustees managing the wells, and other liabilities were not demonstrated to the satisfaction of the Tax Court, to have either actually matured or, if they had, to have not been met by the use of taxpayer's credit.

The burden was on taxpayer to establish its insolvency and the deficiency of proof must operate against it. Although insolvency was in issue from the beginning, taxpayer did not seek to introduce in evidence its balance sheets for the years 1936 and 1937,

---

[5] Since Section 14 (d) (2) requires a corporation to be both insolvent and in receivership, we submit that the *Artesian Water Co.* case cannot be interpreted categorically to mean that the corporation as distinguished from the receiver must be able to satisfy creditors. The corporation is solvent if the receiver in charge of the assets is able to meet the obligations as they mature. Otherwise, receivership alone would bring the corporation within the benefit of Section 14 (d) (2).

which would have been some evidence of whether these liabilities which it claims were real and matured, were actually paid after it received the impounded funds. In a period of more than one year after the Tax Court denied taxpayer's first motion for rehearing on this question (R. 197), it filed two recomputation statements, which apparently accepted the decision. Then, in the final motion for rehearing (R. 286), the matter was again raised and denied. There was no abuse of discretion by the Tax Court in its refusal to open the case and retry the issue. *Jankowsky* v. *Commissioner,* 56 F. 2d 1006 (C. C. A. 10th).

II

Taxpayer is not entitled to a rehearing on the question of the applicability of the deficit credit provisions of section 26 (c) (3) of the Revenue Act of 1936 to its 1936 undistributed net income

Taxpayer predicates its appeal from the refusal of the Tax Court to allow any credit under Section 26 (c) (3) of the Revenue Act of 1936, as amended by Section 501 (a) of the Revenue Act of 1942 (Appendix, *infra*) for its alleged deficit in accumulated earnings and profits at the close of 1935, upon the ground that every fact necessary to show its right to a deficit credit can be established by competent evidence. (Br. 29.) But taxpayer had full opportunity to adequately present its case before the Tax Court, and voluntarily and expressly chose to have the issue of the deficit credit decided on the record as it then stood and now exists. If the interests of justice require any thing, they require an end to this long drawn out litigation.

The original opinion was promulgated on August 20, 1942. (R. 184–213.) Since this was prior to the approval on October 21, 1942, of the Revenue Act of 1942, c. 619, 56 Stat. 798, Section 501 (a) of which added Section 26 (c) (3) to the Revenue Act of 1936, the question of the deficit credit was neither raised by the parties nor discussed by the court. The first motion for rehearing filed on September 17, 1942, obviously also dealt with other matters. (R. 214.) It, however, was first suggested on March 26, 1943, in taxpayer's computation under Rule 50, pursuant to the order of the Tax Court of December 4, 1942. Reference was made only to the balance sheet of December 31, 1935 (R. 103–104), showing an alleged deficit of $172,161.65 but which does not purport to show the deficit to be in accumulated earnings and profits. The necessity for further evidence on the issue was not alleged. (R. 297.) On May 5, 1943, at the hearing on the recomputations submitted, the question of the deficit credit was discussed and taxpayer expressly elected to have the question decided on the state of the then existing record. In response to a question from the Tax Court whether he wished to offer new evidence on the subject, taxpayer's counsel replied (R. 263): "Not entirely new, unless it is required by the Court"; and that he was depending on the evidence then in the record, which consisted only of Exhibit 51, the balance sheet as of December 31, 1935 (R. 264). In fact, all counsel wanted was that the Tax Court "take into consideration the facts already in the record and take that 1942 Act into consideration" (R. 265), and did not "think any

additional memorandum is necessary under the circumstances, as the facts are in evidence now" (R. 267). With the unexplained balance sheet the only evidence in the record, the Tax Court on July 30, 1943, in modifying and supplementing its order of December 4, 1942, on other issues, in effect rejected taxpayer's assertion that it was entitled to the deficit credit. (R. 270.) Revised recomputations were ordered filed, and taxpayer again presented the applicability of Section 26 (c) (3), with no suggestion that additional evidence might be necessary. (R. 273.) The matter was heard on January 5, 1944 (R. 298), and decided adversely to taxpayer on January 24, 1944 (R. 285). Taxpayer again, on February 17, 1944, attacked the order, this time on the ground that the Tax Court did not consider the applicability of Section 26 (c) (3) and that additional evidence which would be "an analysis of the Deficit Account" would be submitted. (R. 287.) It is from the denial of this motion for rehearing that taxpayer prosecutes the appeal on this phase of the case. But the only additional evidence offered by the motion is an analysis of the deficit account. Nothing newly discovered since the hearing on the issue on May 5, 1943, is suggested. As the Tax Court said (R. 300):

> The record evidence has, upon the earlier presentations of the question, been found insufficient to show right to the deficit corporation credit. In the light of the entire record here, and after repeated presentation and consideration of this question, no just reason is found to vacate the decision of January 24,

1944, and the petitioner's motion is therefore denied.

Thus, after the hearing on May 5, 1943, the Tax Court considered the question of the deficit credit in its July 1943 and January 1944 orders, and in its February 1944 denial of taxpayer's motion for rehearing. It is clear why the evidence establishing the right to this credit was found wanting, for the balance sheet in no way demonstrates that the alleged deficit was in accumulated earnings and profits, or that taxpayer was in any way prohibited under California law from paying dividends in 1936.

Section 26 (c) (3), being a credit provision, must be narrowly construed. In order to claim the benefit of the credit, the taxpayer has the burden of showing strict compliance with its terms. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46. And where the taxpayer must rely on state law, he must establish it by a clear and convincing proof. *Helvering* v. *Fitch,* 309 U. S. 149, 156. We must remember that taxpayer is a wasting asset corporation. The California court, in an early decision, held that the then California statute (Civil Code, Sec. 309), which forbade withdrawal of capital or "capital stock" and confined dividends to "surplus profits arising from the business", did not forbid a mining corporation from distributing the net proceeds of its mining operations without provision for depletion, although the necessary result was that something was subtracted from the value of the mine and from the net worth of the investment. *Excelsior Min. Co.* v. *Pierce,* 90 Cal. 131. The present act (Sec. 346) in-

corporates this decision, subject to adequate provision for meeting debts and liabilities and liquidation preferences of outstanding shares. On October 28, 1936, taxpayer received from the trustees in the *Julian* v. *Schwartz* litigation, $112,000 in cash (R. 193), and $17,852.13 paid to the receiver (R. 194). By its own figures, including $17,574.68 as a receivership expense in 1936, its net income was $119,338.82 (R. 196), and its liabilities totaled only $43,789.66.

Taxpayer has not shown it could not have paid the cash dividend from these net earnings, or if it could not, the amount of credit to which it was entitled. Since the preceding accounting period under Section 346 (2) of the California Code may be between six months and one year, and a dividend may be paid from earnings in such period despite the existence of a deficit, the Tax Court surely was not in error in holding that taxpayer had not met the burden of proof that a dividend could not have been paid at the end of December 1936 from the $112,000 in cash received from the trustees in October 1936. And on the balance sheet which portrays the deficit of $172,161.65, a reserve for depletion and depreciation is shown in the amount of $99,979.87. (R. 103.) From a bare appraisal of the balance sheet, to the extent this reserve entered into the amount of the deficit, it must be eliminated, since under California law an impairment of assets based on depletion or depreciation of a wasting asset corporation is no restriction on the issuance of dividends. Neither the right to nor the amount of the credit was proven.

III

Taxpayer expressly waived raising and is not entitled to a rehearing to question the disallowance of additional receivership expenses for 1936

Taxpayer attempts to question on this appeal the propriety of the Commissioner's disallowance of $11,908.53 as additional receivership expenses for the taxable year 1936. In the notice of deficiency (R. 41), the Commissioner stated that $11,908.52 of a total of $17,852.13 claimed as receivership expenses were "disallowed for the reason that these expenses properly accrued prior to the taxable year" (R. 46). Although this matter was put in issue by the pleadings (R. 53) at the trial before the Tax Court, counsel for taxpayer specified that there were five issues involved in the cause, none of which was the question of the receivership expenses, and that counsel for the Commissioner was "correct" in presuming that the other issues set forth in the petition were "waived" (R. 108). The Tax Court then stated (R. 108):

> * * * before you start, you speak about others being waived. I was wondering about that, because there are a large number enumerated here. Are they waived or have some of them been disposed of in your stipulation?

To which taxpayer's counsel replied: "No. They have been waived. They are small items." (R. 108.) The question was not discussed in the briefs or at the hearing under Rule 50. (R. 297.) It is elemental that taxpayer is therefore precluded from raising the question of receivership expenses on this appeal.

Commissioner v. *Fortney Oil Co.,* 125 F. 2d 995 (C. C. A. 6th).

But an examination of the evidence and stipulation clearly shows why the Tax Court cannot be convicted of error in accepting taxpayer's waiver at face value. The claim is obviously without merit. In and after 1933, pursuant to a stipulation filed with the state court having jurisdiction over the trustees in the *Julian* v. *Schwartz litigation,* there were released to J. A. Smith for the account of taxpayer, proceeds of gas production from Wells Nos. 1, 2, 3 and 11. (R. 84, 196.) At the hearing in Washington, D. C., in 1937, with the representatives of the Bureau of Internal Revenue, the parties agreed that these proceeds would be income taxable to taxpayer, in and after 1933, as having been constructively received by it in the years when Smith was paid. (R. 84, 196.) [6] From this income, however, there were allowed as deductions, depreciation on the tangible equipment and business expenses paid and incurred, including legal fees and receivership expenses. (R. 85, 196–197.) The receivership expenses were allowed to the taxpayer as deductions "*in and for the years* in which they were definitely determined and approved by the Court", which had jurisdiction over the receiver. (Italics supplied.) (R. 85.) It should be noted that the expenses were to be allowed as deductions for the *years* the court approved them as proper, not as taxpayer asserts (Pet. Br. 34) for and in the

[6] $2,702.66 in 1933; $2,498.47 in 1934; $2,237.90 in 1935.

year the court did the approving. On November 12, 1936, the receiver filed with the state court a petition for approval to pay receiver's expenses, aggregating $17,852.12. An examination of the petition shows (R. 197) that it specified the incurrence of expenses for the years 1931 to and including 1936, with the exception of 1935.[7] The court approved the account the day it was filed. (R. 198.) Thus, according to the stipulation and arrangement with the Bureau of Internal Revenue, the greater portion by far of these expenses was allowed as deductions in the years prior to 1936. For almost all the out of pocket expenses and a large percentage of the legal and receiver's fees were for services rendered for years prior to 1936 and rightfully approved by the court for those prior years. Taxpayer presumably has already taken the benefit of these deductions in computing its taxable income for these prior years, and cannot now obtain a double benefit by the allowance of the deductions again for the year 1936.

Taxpayer's claim that the Tax Court did consider the question of the receiver's expenses is a play on words. It is true that the court in denying taxpayer's motion of February 17, 1944, for rehearing, said (R. 296–297):

> All of the matters presented by the present motion had, prior to the filing thereof, been

---

[7] A further breakdown of receiver's fees shows them to include $2,893.32 as balance due from the order of the court dated February 1, 1932, and $3,500 for services rendered January 1, 1934 to December 1, 1936, by order of the court. This totals the $6,393.32 mentioned by the Tax Court for 1936. (R. 197.)

> thoroughly considered. On December 4, 1942, motion filed September 17, 1942, for rehearing, including consideration of the issues now raised as to loss on Well No. 16 and insolvency, was denied. The matter of receivership expense was waived at the original hearing, and was not discussed in petitioner's briefs nor at the hearing under Rule 50. The above issues were nevertheless reconsidered because the figures involved were incorporated in the recomputations submitted.

This in no way means that the Tax Court considered the merits of the receivership expense deduction. Despite the express waiver, taxpayer continued to submit for computation of the tax under Rule 50, recomputation statements incorporating the $11,908.53 as an additional deduction. (R. 250, 275.) If the Tax Court looked at the statements at all, it had to consider this figure. It did so, by disallowing the deduction every time it was claimed. Taxpayer expressly waived attacking this item, and no merit lies in the claim. The additional receivership expense was properly disallowed for the taxable year 1936.

IV

Taxpayer has not sustained the burden of proving the amount of any loss sustained in the relinquishment or exchange of its one-half interest in Well No. 16 in 1937

At the outset, it must be emphasized that the amount of the loss sustained in the relinquishment or transfer of taxpayer's one-half interest in Well No. 16 is limited for taxation purposes to $2,000. For the transaction whereby taxpayer quitclaimed its interest

in the well in 1937 to Smith constituted a sale or exchange of a capital asset within the meaning of Section 117 (d) of the Revenue Act of 1936. (Appendix, *infra.*) There can be no doubt that the well was a capital asset (Section 117 (a)), and an analysis of the transaction can likewise leave no doubt of its sale or exchange character.

Under the terms of the United lease (Ex. 26), taxpayer was required to operate Well No. 16 even though in doing so it sustained losses (R. 124, 199). It had sustained an operating loss of $3,258.78 in the operation of the well in 1937 up to the time the well ceased producing because of some unknown damage. (R. 199.) Work of an undisclosed nature was necessary to ascertain the kind and extent of the damage and the cost of making repairs, and Smith, the owner of the other half interest, was not liable for more than $250 per month for operating expenses. (R. 117, 124, 199.)

The choices were clear. Taxpayer could continue operating the well at a loss (R. 139, 140), which was immediately cast aside. Or it could abandon the well. In the event taxpayer did this, the lessors under the United lease had the right to come in and take possession of the well and equipment and operate it free from any claim of taxpayer, with the exception of a royalty of $8\frac{1}{3}\%$. (R. 199.) But there was no assurance the lessors would exercise their rights under the lease to take over the abandoned well. In fact, it appeared likely that they too would not desire to operate it at a loss and there was no reason to expect they

would be more successful at the operation than taxpayer. Thus, in order for taxpayer to elect to abandon the well, it had to assume that it would be obligated under the terms of the lease, to restore the premises to the original condition, and under the laws of California, to condition and plug the well for purposes of abandonment. (R. 134, 199.) It is well settled that a gas, oil, or petroleum well cannot merely be abandoned in California. It has to be conditioned for this purpose to the satisfaction of the Commissioner. Act No. 4916, Sec. 16, General Laws of California (1931, 1937). And this is likely to entail expenditures of substantial sums of money, in the case of Well No. 16, from $5,000 to $10,000. (R. 134, 199.)

But a third choice was open to taxpayer—to surrender its interest in the well to Smith. This would have two effects. It would release taxpayer from any personal liability for conditioning the well for abandonment, and relieve it from the terms of a very undesirable contract connected with its operation. As taxpayer in its brief says (Br. 36):

> By quitclaiming to Smith, petitioner relieved itself of an onerous liability. Under the terms of its 1928 agreement petitioner was required to operate the well, even at a loss, so long as it retained possession. [R. 124, 126.] It undoubtedly chose the course of wisdom in surrendering the well to Smith, for although the well produced over $15,000 worth of oil in 1938 [R. 132–3], as compared with only about $10,000 in 1937 [R. 151], production then declined to about $700 or $800 a month [R. 133],

> and even if petitioner had been able to put the well back on production at a cost of as little as $500, it would have sustained a loss in operating the well because of the limitation on Smith's share of expenses [R. 139–140]. Furthermore, in quitclaiming the well to Smith, petitioner shifted to him the ultimate liability for conditioning the well for abandonment in compliance with state law. This might have cost between $5,000 and $10,000 [R. 134]. By quitclaiming to Smith, petitioner surrendered its interest in the well without incurring this liability.

A loss sustained by a mortgagor or a purchaser under a land contract from a voluntary surrender of the property to the mortgagee or seller *for the release of his personal liability* results from a sale or exchange. *Rogers* v. *Commissioner,* 103 F. 2d 790 (C. C. A. 9th); *Kaufman* v. *Commissioner,* 119 F. 2d 901 (C. C. A. 9th); see also, *Helvering* v. *Hammel,* 311 U S. 504. Taxpayer voluntarily surrendered its interest in Well No. 16 to Smith. By doing so it was released from any liability to condition the well for purposes of abandonment. This was a motivating factor of the transaction. (R. 134.) Taxpayer thus definitely received a *quid pro quo* from the transfer, and Smith took the whole interest in Well No. 16, burdened with the liability of conditioning it in the event of abandonment. This constituted a sale or exchange of a capital asset within the limitation provision of Section 117 (d).

But this question is rendered academic since, as the Tax Court held, the evidence of record fails to prove

the amount of any loss sustained by taxpayer in this connection. (R. 213.) Although in the notice of deficiencies the Commissioner disallowed the loss "as not falling within the provisions of section 23 of the Revenue Act of 1936" (R. 50), and counsel in his opening remarks questioned the bona fides of the transaction, the amount of the loss was expressly put in issue during the testimony of the first witness (R. 119) and thereafter throughout the hearing. The sole evidence introduced was Exhibit 57 (R. 157), which was offered (R. 155)—

> for the purpose of showing the method and the manner in which petitioner arrived at the figure $43,151.96 which the petitioner has claimed to have sustained as a loss on Well No. 16 at the time it was abandoned in 1937 and *not for the purpose of showing that it is evidence of the fact that they did sustain that,* but to show how we arrived at that figure, to show our method of computing. [Italics supplied.]

Taxpayer asserts (Pet. Br. 39) that if this were admitted just to show the method of computation, it would have been entirely immaterial. So counsel for the Commissioner thought when he objected to the offer on just this ground (R. 156) and the Tax Court in overruling the objection explained "It may not be highly material" but that it might still be helpful for the purpose offered. (R. 156.) The record belies the suggestion that the only reason the exhibit was objected to was that it contained a disputed element of depletion. (Pet. Br. 40.) With the examination of the first witness taxpayer was ap-

prised at the outset that it was charged with proof of the cost or other basis of the well for purposes of ascertaining the amount of any loss sustained. Yet it went through the entire hearing without introducing any substantive evidence of the amount of its loss.

The record is thus barren of any evidence upon which the Tax Court or this Court could base a finding of the adjusted basis of the well. After the Tax Court denied taxpayer's first motion for rehearing on this issue (R. 297), taxpayer in a period of more than one year, filed two recomputation statements, which apparently accepted the decision. Then in the final motion for rehearing (R. 286), the matter was again raised and denied (R. 297). There was no abuse of discretion by the Tax Court in its refusal to open the case and retry this issue of the adjusted basis of Well No. 16 for purposes of determining the amount of the loss. *Jankowsky* v. *Commissioner,* 56 F. 2d 1006 (C. A. A. 10th).

Taxpayer's attack upon the statements of the Tax Court on the interpretation of the figures in Exhibit 57, *were they in the record as such,* is in vain. At most, this analysis by the Tax Court was a gratuitous undertaking to show taxpayer that the mere fact it proved the book entries proved very little. See *Rieck* v. *Heiner,* 25 F. 2d 453 (C. C. A. 3d). Since the adjusted basis was contested, there is no doubt taxpayer would have to demonstrate that for taxation purposes the amounts portrayed represent the correct figures for depreciation and that intangible drilling costs had not been deducted as expenses in the years in which they were incurred, as permitted by the

Treasury Regulations.[8] For taxpayer was the assignee of part of the leasehold interest which Barnhart acquired under the United lease and which obligated Barnhart to drill. When taxpayer drilled Well No. 16, it was therefore developing its own lease and the expenses incurred were properly deductible at taxpayer's option. See *Hardesty* v. *Commissioner,* 127 F. 2d 843 (C. C. A. 5th).

CONCLUSION

There was no abuse of discretion in denying the taxpayer's motion for rehearing and the decision of the Tax Court should be affirmed.

Respectfully submitted,

SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
A. F. PRESCOTT,
LEONARD SARNER,
Special Assistants to the Attorney General.

OCTOBER 1944.

---

[8] See, for example, Regulations 74, promulgated under the Revenue Act of 1928, Art. 243.

APPENDIX

Revenue Act of 1936, c. 640, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

*　　*　　*　　*　　*

(d) *Exemption from surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

*　　*　　*　　*　　*

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

*　　*　　*　　*　　*

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*

(1) *Trade or business expenses.*—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

*　　*　　*　　*　　*

(f) *Losses by corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

*　　*　　*　　*　　*

(h) *Basis for determining loss.*—The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e) or (f), shall be the adjusted basis provided

in section 113 (b) for determining the loss from the sale or other disposition of property.

*　　*　　*　　*　　*

(j) *Capital losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).

*　　*　　*　　*　　*

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

*　　*　　*　　*　　*

(c) [as amended by Section 501 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Restrictions on payment of dividends.*—

*　　*　　*　　*　　*

(3) *Deficit corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

*　　*　　*　　*　　*

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

*　　*　　*　　*　　*

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

*　　*　　*　　*　　*

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(b) *Definition of capital assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on capital losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

* * * * *

Civil Code of California (Deering, 1933 Supp.):

SEC. 346. CASH OR PROPERTY DIVIDENDS.—A corporation may declare dividends payable in cash or in property only as follows:

(1) *Out of earned surplus;* or

(2) *Despite the fact that the net assets of the corporation amount to less than the stated capital,* out of net profits earned during the preceding accounting period which shall not be less than six months nor more than one year in duration; or

(3) *Out of paid-in surplus or surplus arising from reduction of stated capital* subject to the provisions of section 348b, Civil Code, only upon shares entitled to preferential dividends; provided that notice shall be given to the shareholders receiving such dividends of the source thereof prior to or concurrently with the payment thereof.

If the value of the net assets amounts to less, through depreciation, depletion, losses, or otherwise, than the aggregate amount of stated capital attributed to shares having liquidation preferences, the corporation shall not declare dividends out of net profits pursuant to subdivision (2) of this section, except upon such shares, until the value of the net assets has been restored to such aggregate amount of the stated capital attributed to outstanding shares having liquidation preferences.

No dividends shall be declared when there is reasonable ground for believing that thereupon the corporation's debts and liabilities would exceed its assets, or that it would be unable to meet its debts and liabilities as they mature.

No dividends shall be declared out of the mere appreciation in the value of its assets not yet realized, nor shall any dividends be declared from earned surplus representing profits derived from an exchange of assets unless and until such profits have been realized or unless the assets received are currently realizable in cash.

A wasting asset corporation, that is a corporation engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents or other wasting assets, or organized solely or

substantially to liquidate specific assets, may distribute the net income derived from the exploitation of such wasting assets or the net proceeds derived from such liquidation without making any deduction or allowance for the depletion of such assets incidental to the lapse of time, consumption, liquidation or exploitation; subject, however, to adequate provision for meeting debts and liabilities and the liquidation preferences of outstanding shares and to notice to shareholders that no deduction or allowance has been made for such depletion. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1944